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April 16, 1996

William F. Caton
Acting Secretary
Federal Communications Commission
Washington, D.C. 20554

APR 16 1996

Re: Ex Parte Comments
CC Docket No. 94-1
Price Cap Performance Review for Local Exchange Carriers

Dear Mr. Caton:

For 1995, the price cap local exchange carriers (LECs) reported aggregate earnings of 14.1 percent (see attached table). These extremely high earnings provide clear evidence that the Commission's price cap plan has not kept the promise of balancing consumer benefit with supplier profits. Despite very healthy earnings, the price cap LECs have filed aggregate access charge increases of \$14 million. These facts reinforce the CARE coalition's analyses that the record in the LEC price cap performance review supports a substantial increase in the productivity adjustment, or X-factor. The Commission must complete its price cap performance review quickly to prevent any future unwarranted LEC price increases resulting from the current inappropriate productivity adjustment.

Total Factor Productivity (TFP) studies filed by members of the CARE coalition show that the LECs have been able to achieve interstate productivity of as much as 9.9 percent over the last five years. The LECs' choice of X-factor, coupled with their high returns under the Commission's original and interim price cap plans, provide further evidence supporting the CARE analysis calling for an X-factor between 8 and 10 percent.

A straightforward analysis reveals the productivity expectations of the price cap LECs. Each LEC must decide how its earnings would be affected by either lowering price up front and not sharing excess earnings with consumers, or keeping prices high and sharing excess earnings. By estimating their productivity, each LEC can determine algebraically which X-factor option to select that provides the greatest retained earnings. Therefore, their selection

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provides insight into the expected productivity levels which the LECs must achieve to produce their expected returns.

For a LEC to have chosen an X-factor of 5.3%, which has no sharing obligation, it would have had to expect to achieve a productivity level that would allow it to retain higher earnings than it would if it chose one of the lower X-factor options that had a sharing obligation. In the current price cap plan, if the LEC expects to achieve an X-factor of 8.54%, it can expect to achieve earnings of 12.75%. At any productivity level below 8.54%, the LEC could retain higher earnings if it chose the lower productivity factor of 4.0%, and accepted the resulting sharing obligation.¹ Similarly, under the Commission's original price cap plan, the break-even rate of return was about 14.8 percent, which implies a break-even productivity level of almost 11 percent. Because the LECs in general chose the lower X-factor, this implies that they expected their productivity gain to be no more than 11 percent.

The LECs' performance in 1995 falls squarely within this range of 8.5 to 11 percent, as CARE demonstrates below. The LECs' aggregate price cap earnings of 14.1 percent were 2.85 percentage points above the rate of return of 11.25 percent at which price cap rates were initialized. Two (2) percentage points on the X-factor results in an approximately 1 percentage point change in the rate of return. The 2.85 percentage points translates to an X-factor that would have been about 5.7 percentage points higher in 1995, while still allowing the LECs to have earned 11.25 percent. The X-factor for 1995 could therefore have been set at 10 percent, as the CARE coalition members' TFP studies indicate, and the price cap LECs as a whole would still have achieved earnings of 11.25 percent.² Moreover, because the LECs' required cost of capital has fallen below 11.25 percent,³ an X-factor of 10 percent or more is needed to reflect the results that would be expected in a competitive market.

¹ This estimate of the X-factor conservatively assumes that the LECs pay only federal income tax at the rate of 35%. If the analysis also included state income tax, the X-factor at which the LECs would achieve the same earnings under the 5.3% option would be even higher.

² Most LECs chose an X-factor of 3.3 percent in the 1994 annual access filing, which governed the first half of 1995, and an X-factor of 5.3 percent in the 1995 annual access filing, which governed the second half of 1995, yielding an average X-factor of 4.3 percent.

³ See, e.g., Attachment A of MCI's comments filed March 11, 1996 in Preliminary Rate of Return Inquiry, AAD 96-28 and 95-172, which showed that the LECs' composite cost of capital has fallen to 9.48 percent. This result is also consistent with the cost of capital found by the Washington Utilities and Transportation Commission for U S West's state services, of 9.36 percent. See Washington Utilities and Transportation Commission, Fifteenth Supplemental Order, Docket No. UT-950200, released April 11, 1996.

It is critical that the Commission select X-factors that ensure that ratepayers receive the benefits of LEC cost reductions. Whether the Commission adopts a single set of X-factors that will be used until a further review, or adopts a rolling-average method for continually updating the X-factor, it is clear that the X-factor must be substantially raised.

The CARE coalition urges the Commission expeditiously to complete the LEC price cap performance review, raising the X-factor to a level which will ensure that ratepayers share in the benefits of reductions in the LECs' costs. The Commission's existing price cap plan has allowed the LECs to increase their accesscharges on July 1, even though they have earned well in excess of their cost of capital in the prior year. The longer the Commission delays in resolving the price cap docket, the longer the LECs will be able to maintain rates that are too high, harming ratepayers and hampering the development of competition in the local and long-distance telecommunications markets

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Bradley Stillman", with a stylized flourish at the end.

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For the CARE Coalition:

National Association of State
Utility Consumer Advocates

Telecommunications Resellers
Association

Ad Hoc Telecommunications
Users Committee

MCI Telecommunications Corp.

Consumer Federation of America

LDDS Worldcom

AT&T Corp.

American Petroleum Institute

International Communications
Association

Comptel

PRICE CAP LEC EARNINGS, 1995

Carrier	Net Return	Average Net Investment	Rate of Return
Ameritech	576,169	3,093,308	18.63%
Bell Atlantic	606,963	4,420,570	13.73%
BellSouth	728,645	4,627,473	15.75%
NYNEX	449,547	3,705,819	12.13%
Nevada Bell	12,118	70,221	17.26%
Pacific Bell	370,676	2,451,590	15.12%
Southwestern Bell	448,306	3,351,986	13.37%
US West	465,054	4,007,152	11.61%
GTE/Contel	534,918	4,430,273	12.07%
Sprint	251,031	1,335,745	18.79%
Lincoln	8,292	51,541	16.09%
Rochester	31,761	199,787	15.90%
SNET	55,282	477,342	11.58%
Total Price Caps	4,538,762	32,222,807	14.09%

Ameritech net return is adjusted to include \$57 million for add-back.